Firstlinks
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This Week's Top Articles

Let's stop calling them 'bond proxies'

Graham Hand

Imagine if you could nominate the one factor which has been most important in driving share markets to recent all-time highs. It would not only explain the past decade, but it could guide your future investing. So, what's your suggestion?

Famous US fund manager, Howard Marks, has been publishing a quarterly memo to his clients for 30 years, and he's seen it all in investment markets. In his latest memo, he answers this question without qualification:

"Low rates reduce the discount factor used in calculating the net present value of future cash flows. Thus, all else being equal, there's a direct connection between declining interest rates and rising asset prices.

I consider this to have been the dominant feature of the world of finance over the last ten years.

Low rates on savings and fixed-income investment drive investors to accept increased risk in order to pursue decent return in a low-return world."

What if, in this search for yield, investors could have the best of most worlds: predictable income as offered by term deposits or bonds, high yields no longer available from fixed income, and the potential for some capital growth. Almost everything except a bond's defined maturity value at a future date.

Welcome to the world of so-called 'bond proxies'.

A 'proxy' can be 'used to represent the value of something else'. Certain types of investments such as infrastructure and commercial property often have long-term monopoly locations with contractual payments from governments or large companies. Think airports, roads, ports, power stations, bridges, office blocks and distribution centres.

Are these three types of investment really alternatives to bonds or term deposits, or is bond proxy a misnomer? We'll consider this in the context of listed securities, but hundreds of unlisted funds offer each asset class as well.

1. Listed infrastructure

Many companies listed on Australian exchanges offer revenue streams that have some bond-like characteristics. Sydney Airport (ASX:SYD) has a monopoly on air traffic into Australia's largest city. It has exceptional pricing power, as anyone who has parked there or bought a coffee will know. It's as much a shopping centre and a car park for captive consumers as it is a place where planes arrive and depart.

But it is not immune from equity-like risk. A global epidemic similar to SARS or an economic recession might reduce traveller numbers. Conflict between major super powers, or even war, could dramatically impact global travel. It's conceivable that a cyber attack could hit the airport's systems, or terrorist activity threaten the safety of flying.

Most of these risks relate to global travel, so what about Transurban (ASX:TCL), which owns many of Australia's major toll roads? When the Eastern Distributor opened in Sydney in 1999, the toll for a car was $3.50. It's now $7.69. What a great business, especially when the alternative is a painful traffic jam. But what about the future impact of driverless vehicles, or the dates when the concessions lapse and return to the government. One day, will we have flying vehicles which do not need roads?

Other infrastructure stocks include the APA Group (ASX:APA) which owns gas pipelines in every mainland state and territory, delivering half of the nation's gas usage. Aurizon (ASX:AZJ) is a leading rail freight operator, transporting 250 million tonnes a year across a national network. These businesses are the essential plumbing of the Australian economy, and are considered defensive assets and less prone to economic downturns.

One way to reduce specific company risk to invest in an infrastructure fund listed on the ASX, and here are the choices:

- Argo Global Listed Infrastructure Limited (ASX:ALI)
- ETFS Global Core Infrastructure ETF (ASX:CORE)
- AMP Capital Global Infrastructure Securities Fund (ASX:GLIN)
- VanEck Vectors FTSE Global Infrastructure (Hedged) ETF (ASX:IFRA)
- Magellan Infrastructure Fund (Currency Hedged) (ASX:MICH)
- Vanguard Global Infrastructure Index ETF (ASX:VBLD)

These funds have different structures which may affect their appeal. Argo is a Listed Investment Company which means the shares can trade at a discount or premium to the value of their assets. This 'open-ended' form is at once an opportunity and a problem.

Both Magellan and AMP are actively managed, while the others replicate infrastructure indexes and offer lower fees.

2. Listed property

The more common name for listed property is Australian Real Estate Investment Trusts, or A-REITs, which are trusts which hold different types of property. The sector is currently offering a 4.5% dividend yield, and contractual rental arrangements make profit and dividend growth reasonably predictable at about 3 to 4% per annum. There are also property managers who operate the funds.

There are dozens of listed property investments, too numerous to list here, including smaller trusts in specialist segments. The leading names are Stockland (ASX:SGP), Scentre (ASX:SCG), GPT Group (ASX:GPT), Goodman (ASX:GMG), Charter Hall (ASX:CHC) and Unibail-Rodamco-Westfield (ASX:URW).

During the GFC, many listed property trusts fell heavily in price because they carried high gearing and had ventured overseas into less-understood markets. Business methods are far better now, with lower gearing and a strong focus on Australia.

A crucial factor in A-REITs is the division into segments of office, retail, industrial and residential, and investors should consider the future merits of each as an investment. In 2018/2019, for example, the property fund managers, Charter Hall Group (up 72%) and Goodman Group (up 60%) both benefited from strong demand for the A-REITS they manage in growth segments such as commercial offices and industrial logistics. However, Unibail-Rodamco and Scentre fell 27% and 8% respectively due to concerns about exposure to the discretionary retail sector.

There are also property ETFs such as the Vanguard Australian Property Securities Index ETF (ASX:VAP), the SPDR S&P/ASX200 Listed Property Fund (ASX:SLF) and AMP Capital's Global Property Securities Fund (ASX:RENT). A listed vehicle that combines both infrastructure and listed property is the BetaShares Legg Mason Real Income Fund (ASX:RINC) which holds A-REITs, gas, electricity, port and toll road listed asses in one fund.

3. Equity income funds

Many investors are turning to higher dividend yields to compensate for lower fixed income returns, but the move comes with obvious risks. Over the last 75 years, the Australian share market has experienced 40 falls of over 10%, so share investors must expect this level of correction regularly over all investment cycles. Worse, in 1974, 1987 and 2007, the market fell by over 50%, often with little warning or valuation excesses.

Every investor has a different appetite for risk, and just because a fund is called 'equity income' does not mean it is less likely to fall in value. It might have an income focus, but it is still an equity fund.

Despite the experience in a stock like AMP (ASX:AMP) which has suspended its dividends, or Telstra (ASX:TLS) which has reduced its dividends, most companies sustain their dividends during a market sell off. Dividends are more resilient than share prices, and equity income funds certainly produce higher income as some compensation for the added risk. An equity income fund in the current market can produce a dividend yield of around 6% or 8% grossed up for franking credits.

Equity income funds concentrate their investments in the large dividend-paying stocks of banks, Telstra, Wesfarmers and more recently, BHP. It is a stretch to call these investments 'bond proxies', as banks are leveraged companies exposed to economic cycles, and resource companies are subject to volatile commodity prices. Investors should consider the total return, including capital gains and losses, not only income. Nevertheless, 8% fully-franked is difficult to resist for at least part of a portfolio.

Examples of listed equity income Exchange Traded Funds (ETFs) are:

- Australian Dividend Harvester Fund (ASX:HVST)
- Vanguard Australian Share High Yield Fund (ASX:VHY)
- iShares S&P/ASX Dividend Opportunities ETF (ASX:IHD)
- SPDR MSCI Australia Select High Dividend Yield Fund (ASX:SYI)
- BetaShares Legg Mason Equity Income Fund (ASX:EINC)
- Equity Yield Maximiser Fund (ASX:YMAX)

Other variations include a fund specifically investing in Australian banks, the VanEck Vectors Australian Banks ETF (ASX:MVB), global income funds such as the S&P500 Yield Maximiser (ASX:UMAX) and actively-managed Listed Investment Companies like Plato Income Maximiser Limited (ASX:PL8).

Don't be tricked by the 'bond proxy' label

As with share investments, however, they are subject to overvaluation when investors chase predictable revenue, and their share prices will fall in a major market correction. They may reduce dividends or suffer adverse market reaction if interest rates rise.

The macro environment of central banks injecting liquidity and pushing down interest rates has been a perfect environment for so-called bond proxies, but the threat of trade and currency wars and slowing economic growth might push bond proxies more into the equity proxies camp.

The reality is that although cash flows may be long term and more predictable than some companies, the shares listed above lack a crucial characteristic of a bond: the contractual obligation of the issuer to repay principal at maturity. Regardless of what happens to interest rates, a bond with a maturity value of 100 will pay 100 except where the issuer faces financial difficulty or default (in the universe of investment grade bonds rated AAA, AA, A and BBB, the average default rate is around 2.5%). Although bonds can suffer a fall in value during their term as rates rise, so too will bond proxies which benefitted from the rate fall. During tough market conditions, bonds are likely to outperform, and bond proxies do not carry the same defensive characteristics as term deposits.

Investors should resist the urge to attach the bond proxy label on infrastructure, property and equity income, but accept them for what they are. They have a legitimate role in a portfolio as income-producing, quality assets that will be subject to market forces with no guarantee of a return of capital at some future maturity date.

Graham Hand is Managing Editor of the Cuffelinks Newsletter. This article is general information and does not consider the circumstances of any investor.

99% of listed companies disappear worthless

Ashley Owen

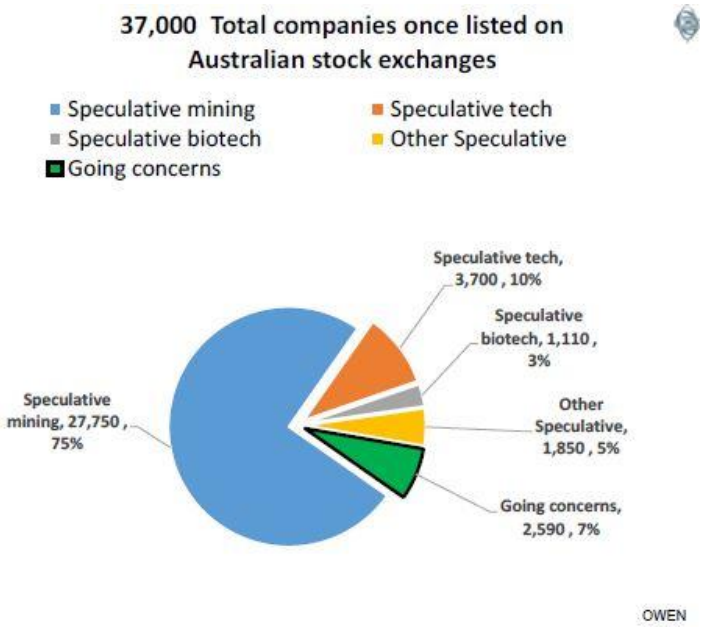
When we talk about returns from 'Australian shares' or the 'Australian stock market', what do we actually mean? Australian stock markets have always consisted of a small number of 'investment grade' companies with real businesses, but the vast majority of companies are, and have always been, high risk speculative gambles.

They are little more than a way for promoters and brokers to harvest money from the pockets of the seemingly never-ending waves of newly-minted speculators hoping to hit the jackpot, much like a casino.

37,000 companies tried, only 580 still listed and profitable

The chances of finding a winner on stock exchanges in Australia has been around 1%. Not a 1% chance of beating the overall 'market index'. I mean 1% just managing to survive and build a profitable business. Here's why.

I estimate that there have been about 37,000 companies that have raised money from investors and listed on one or more of Australia's stock exchanges at some time since the early 1800s. Today, there are only 2,300 companies left still listed on the ASX (6% of the total ever listed) and only 580 of those make any money. So what happened to the rest of them, and what happened to investors' money?



NB The number of companies are the author's estimates based on a study of dozens of exchanges.

In addition to the above, at least 3,000 Australian companies listed on the London market to harvest money from gullible Brits. Their success rate has been even lower.

What we know today as the national 'ASX' is an amalgamation of the stock exchanges of Sydney, Melbourne, Adelaide, Perth, Brisbane and Hobart in 1979. In addition there have also been several other thriving exchanges over time – mainly in mining booms – including Bendigo, Ballarat, Kalgoorlie, Charters Towers, Newcastle, and more. Each of the stock exchanges was owned by separate groups of brokers, all frantically finding and listing companies to attract money from over-eager investors in the boom years.

How do most companies disappear from the exchange?

I estimate that at least 75% of all companies ever listed in Australia were speculative mining ventures. The vast majority of these raised money quickly in the mining boom of the day and then disappeared worthless. The money taken from investors was pocketed by the promoters or exhausted looking for riches that were never discovered in profitable quantities. The most famous mining bubble stock was Poseidon in the late 1960s nickel boom. It did indeed discover a large nickel reserve in WA but it ran out of money trying to exploit it. Most mining explorers found nothing.

Another 6,500 or so companies were other non-mining speculative ventures, including tech stocks, biotech or other ventures in all sorts of other industries. (By 'speculative' I mean no profits or dividends).

That leaves only around 7% of companies that have listed over the years, or around 2,500 companies, that had actual businesses with real customers and positive cash flows.

If 37,000 companies were listed and only 2,300 remain today, where did the other 94% go?

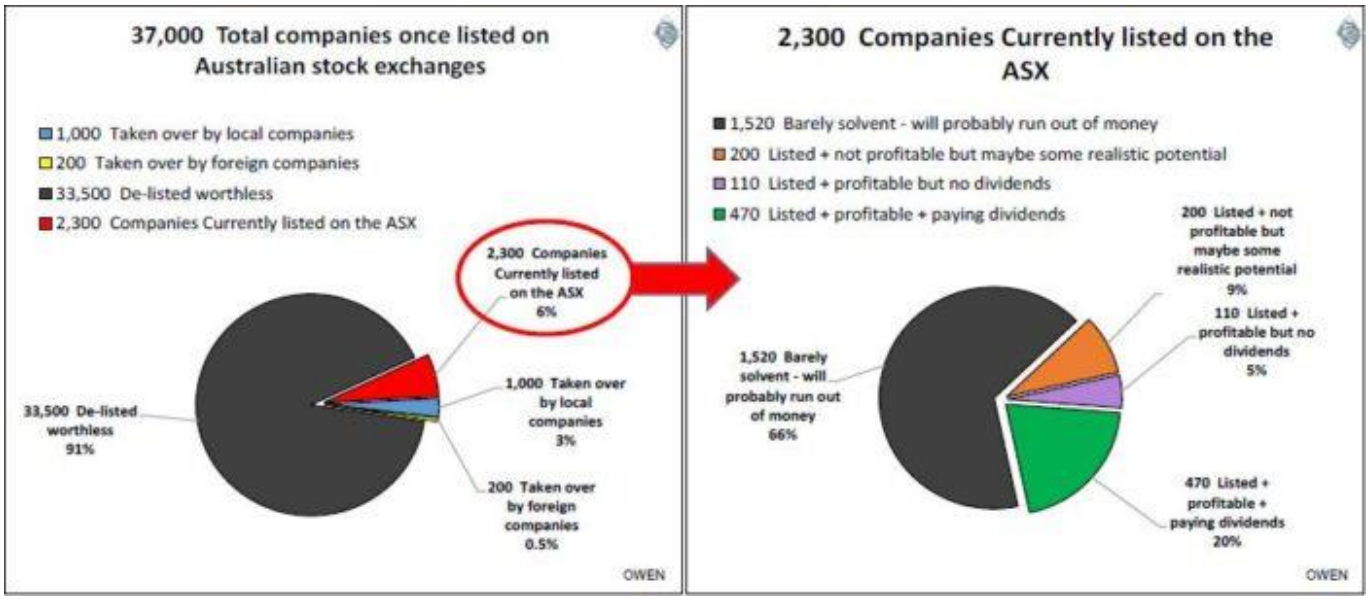
Up to 1,000 of them, or about 3%, were taken over by other local companies. Some of these generated real value for shareholders, for example BHP taking over Western Mining, and the 35 banks that amalgamated into the big four today.

However, the vast majority were mining explorers that were mopped up at very low prices by promoters with high hopes of dressing them up again to take another shot at the next round of gullible 'investors'. There have been variations on this theme, such as failed miners dressed up as 'dot-coms' for the late 1990s 'dot-com', then failed 'dot-coms' dressed up as miners in the 2003-2007 mining boom, and now failed miners dressed up as 'fintechs'(e.g. Decimal Software, Bulletproof Group).

There were also around 200 listed companies that were taken over by foreign companies, such as all of the big Aussie brewers, Optus, BRL Hardy, Alinta, DUET, Rinker, and Westfield.

That leaves 33,000 (or so) companies that disappeared.

There were some colossal bankruptcies like Bond, Qintex, HIH, ABC Learning, Babcock & Brown, Allco, MFS, Timbercorp, etc, but most never saw the light of day. They simply ran out of money and de-listed worthless.



Most of the current listed companies will probably end up worthless

Looking at the still-listed 2,300 'survivors' from the original 37,000 or so (in the right chart above):

- 470 companies (17% of the current list, or just 1.3% of the all companies that have been listed in Australia) are profitable and paying dividends. Although there are 2,300 listed companies in Australia, nearly half of their combined total profits and dividends come from just six companies – the big four banks, BHP and RIO, which are all more than 100 years old.
- Next there are another 110 companies that are profitable but pay no dividends. Many these probably have at least a decent chance of survival and success.
- Next there are possibly another 200 listed companies (I am probably being generous here) that make losses and pay no dividends, but they might have some realistic prospects for success. Nobody knows which ones they are, but there must be a hundred or so.

That leaves the remaining 65% of currently-listed companies or around 1,500 in the current batch. These are barely solvent and will probably run out of money and suffer the same fate as the 33,000 or so other failures that disappeared worthless before them.

Why is this important?

It is important in understanding the difference between **investing** (what we do here) and **speculating** (gambling).

It is also important for setting expectations about likely risks and returns. When we talk about the 'All Ordinaries index' or the 'the Australian stock market' generating returns of 10% p.a. for the past 50 years or 100 years, we mean indexes of 'investment grade' companies only, which is a fraction of the total number of listed companies.

Even the broadest current index, the 'All Ordinaries Index', covers just 490 stocks or 20% of listed companies. Other than the returns from the indexes of the tiny minority of 'investment grade' companies, if we were to track down and measure what happened to investors' money in the other 95%+ of listed companies, it would be a vast sea of red ink, punctuated by the rare huge jackpot for the few lucky winners.

The overwhelming majority of listed companies in any given era are speculative stocks with nothing but hope and hype and almost all will disappear worthless.

I often come across 'investors' who point to their portfolios of a dozen or so tiny speculative stocks and say:

"Look, I've got a diversified portfolio of lithium mining, wind farms, solar, rare earths, plus some biotechs and this fintech. Even if I don't hit the jackpot with any of them, I should get decent market returns from them if I hold them long enough!"

In the words of Darryl Kerrigan in the classic Aussie movie, The Castle: ***"Tell him he's dreamin'"***

We wish them well of course in their quest to hit the jackpot and strike it rich, but that's gambling, not investing.

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What can Australian supermarkets learn from the UK online experience?

Jim Power

"The stakes are high to get this next stage of online growth right."

Australian retailers are rapidly increasing their online penetration and looking at how best to fulfil the growing demand. Coles recently announced an exclusive partnership with Ocado, who have generally been acknowledged as the world's best in online fulfilment.

As part of a recent research trip to the UK and Europe, I spent time meeting with local online grocery experts to understand the implications of this deal for Coles, supermarkets and other Australian retailers.

Who is Ocado and why is it a big deal?

UK-based Ocado is the world's largest dedicated online grocery retailer. They have no physical stores. Their proprietary fulfilment solution is available to commercial partners like Coles, and includes the software, hardware, services and support.

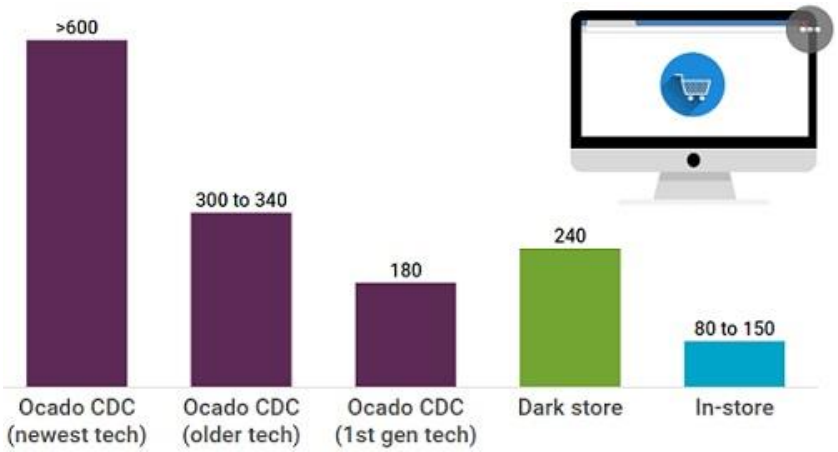
I was interested to find out what makes Ocado's system special, and the experts tell me that it is how they 'pick'. Picking, i.e. getting the items off the shelves in the store or warehouse, is said to make up 40% of total fulfilment costs.

There are three main camps on picking, and some UK brands use a combination:

- **In-store picking** leverages existing capital. Coles have predominantly been doing this until now.
- **Dark stores** look similar to standard stores but with staff but no customers. Coles is currently trialling a dark store in Melbourne.
- **Automated centralised distribution centres** or 'CDCs'. Coles has committed to build two Ocado-system CDCs in Melbourne and Sydney.

The experts I met with concur that picking costs for in-store and dark stores are way behind the best-in-class offerings from Ocado due to average pick rates for items per hour as shown in Chart 1.

Chart 1: Average pick rates per hour



Source: Martin Currie Australia, interviews with online grocery experts.

How do you want that delivered?

'Last mile' delivery is one of the largest costs, so an important factor for success. Physical stores have an advantage due to their proximity to customer homes. Dark stores and CDCs are generally slower as they are based in cheaper industrial areas.

However, in terms of drop rates per hour, my sources tell me that Tesco (in-store) and Ocado (CDCs) are both around 4/hr due to Ocado's intelligent routing. The question will be whether Coles can achieve this too.

In comparison, food aggregators such as Deliveroo or Uber average even less at 2/hr and are loss making but they make up this cost with a high revenue share from partner businesses.

Interestingly, in March 2019 Coles quietly started an UberEats trial in Sydney, delivering essentials such as milk, bread, fresh fruit and vegetables.

What does it cost to implement?

The capital expenditure on the new CDCs will set Coles back $150 million over the next four years but they are looking to double online deliveries with this initiative. They plan to service metro areas via CDCs, with non-metro orders fulfilled by the store network. This is like the deal that Morrisons has with Ocado.

In less than four years, Ocado's system has propelled Morrisons to a larger online market share than Waitrose, despite starting much later. Morrisons have however recently loosened ties with Ocado, allowing Ocado to work with other competitors such as Tesco, Sainsbury's, Asda, Aldi and Lidl.

What's the alternative for other supermarkets?

Ocado have spent 18 years getting their customised offer right but there are alternatives for Australian companies, such as Woolworths and Metcash**,** given Coles' exclusive deal with Ocado. Alphabot, a collaboration between Alert Innovation and Walmart, is said to be the one to watch, as it's designed to automate an existing store footprint. Amazon's model works well outside grocery, but has no proven grocery offering (but watch this space). Others include Instacart**,** Autostore and Picnic.

What's at stake?

Ocado is a leader with a 20% share of the UK online market. Online is 6% of the total grocery spend and is predicted to grow to 9% by 2021. While UK online growth is starting to mature, Australia has space to grow from its low base. Online currently only makes up around 3% of the total Australian grocery spend.

Coles has a 45% share of the online grocery market but Woolworths is currently in front. Doubling online sales would add around $1 billion to Coles' books.

In summary

The stakes are high to get this next stage of online growth right. Locking in Ocado may give Coles a boost for now, but Woolworths, with a team of 500+ at the WooliesX headquarters in Surry Hills, will be taking this development seriously.

Sources: Coles and Woolworths company reports, Ocado company reports, IGD, Statista, Martin Currie Australia.

Jim Power is a Research Analyst at Martin Currie, a Legg Mason affiliate. Legg Mason is a sponsor of Cuffelinks. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable. Please consider the appropriateness of this information, in light of your own objectives, financial situation or needs before making any decision.

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Bracket creep quietly increases your tax bill

Tony Dillon

The recently legislated tax cuts are welcome for many taxpayers, but they are largely payback for the effects of wage inflation and bracket creep. People often think only of bracket creep as the process where wages push into a higher tax bracket due to inflation.

But it is more encompassing than that, and can also have an effect within marginal tax brackets.

How marginal tax rates work

Consider a tax system with a 30% rate of tax on income in excess of a tax-free threshold of $20,000.

A wage earner on $50,000 will pay $9,000 tax (30% of $50,000 less $20,000), with take-home pay of $41,000.

Suppose wage inflation pushes his salary up 5% to $52,500. The tax bill becomes $9,750, and take home pay $42,750. So net of tax, pay has increased by 4.3%, which is less than the 5% increase in gross earnings.

In this case, wage inflation has not pushed the wage earner into a higher tax bracket, but the wage earner's net of tax pay has not kept pace with inflation. 'Bracket creep' a bit of a misnomer. It's more like 'tax creep'.

To negate so-called bracket creep, the thresholds at which marginal tax rates change should be indexed to inflation. Assume therefore that the tax-free threshold in our example becomes $21,000 (a 5% increase). Then the tax bill becomes $9,450, and net pay $43,050. In this instance, take home pay has also increased by 5%. That is, there is no bracket creep when the tax-free threshold is indexed.

The problem is, governments of the day do not index tax thresholds regularly, meaning wage earners suffer a silent increase in the tax burden.

Bracket creep is an outworking of a progressive tax system, such that the total tax paid as a percentage of income (the average tax rate) increases with income earned. A regressive system does the opposite. A progressive system is constructed by setting higher marginal tax rates at higher income bands.

We have always had a progressive income tax scale in Australia. For example, on the 2018/19 tax scale, someone earning $45,000 pays $5,892 tax, while a taxpayer on $200,000 pays $67,097, or 11.4 times more. Clearly that's progressive.

Bracket creep is regressive in our progressive tax system

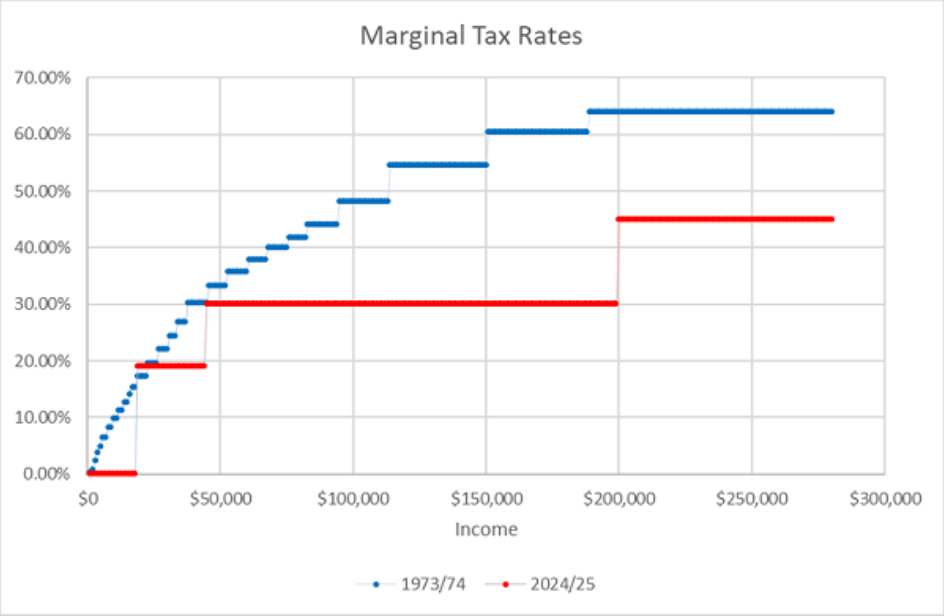
Perversely though, bracket creep acts regressively because average tax rates increase more sharply at lower income levels before flattening out at higher income levels. Bracket creep can act as a drag on the incentive to work and earn more, as every extra dollar pushes the average tax rate higher. At the extreme, it can discourage employment and ambition and encourage tax avoidance.

In general, the more income tax brackets, and the wider the spread of marginal tax rates, the more progressive the tax system. And the more progressive the tax system, the greater the impact of bracket creep.

Remarkably in the 1973/74 Australian tax year, there were **29 income tax brackets with a top marginal rate of 66.7%**, which yielded a highly-progressive tax scale. And that, coupled with inflation hitting an incredible 15.8% in 1974, meant that bracket creep was a huge issue.

Contrast that with the recently-legislated Coalition tax scale for 2024/25 of only four tax brackets, with a super-sized bracket of income between $45,000 and $200,000 taxed at a marginal rate of 30%, and a top rate of 45% beyond that.

In fact, if we indexed the 29 different tax bracket thresholds in 1973/74 for 51 years of inflation to 2024/25, we can compare the two tax scales at the same income levels. Inflation from 1974 to 2018 averaged 4.9% p.a., then we extrapolate that for another seven years at a more modest rate to reflect current low inflation until 2024/25. The first chart below shows how marginal rates step through increasing income levels for both tax scales. The sheer number of tax brackets in 1973/74, stepping up to a marginal rate of over 60%, is evident.

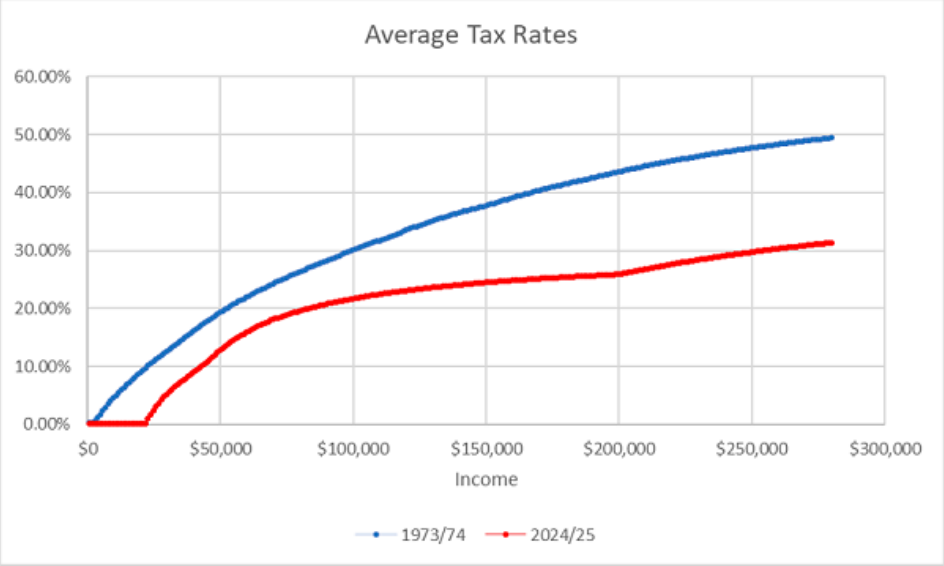


Progressivity has fallen over time

Of perhaps more interest is comparing the average tax rates of the two tax scales, for increasing income levels. In the chart below, the average tax rates have shifted down at all income levels since 1973/74, with a wider gap at the higher income amounts, as a consequence of a flatter 2024/25 curve. It shows progressivity, or the degree to which a tax system is progressive, has fallen. Note, the 2024/25 curve includes the low income tax offset, but excludes the Medicare Levy.

The 2024/25 tax scale is less progressive than previous editions, but someone earning $200,000 will pay nearly 10 times more tax than someone on $45,000.

In terms of revenue collected, Treasury projects that the top quintile of income earners will still pay around 60% of all tax in 2024/25. And a positive consequence of less progressivity of course, is the dampening of the bracket creep effect.



Therefore over time in Australia, we have been trending towards a flatter tax system, where bracket creep becomes less of an issue.

Is there a case for a proportional system?

In fact, one wonders if we will ever reach the extreme, dare we say, of a proportional tax system, where the average tax rate remains the same at all income levels. Just one tax rate, no matter the income. It's a system that would eliminate the effect of bracket creep entirely and that would be neither progressive or regressive by strict definition.

Such a system would encourage initiative, innovation, further education, and the willingness to earn more, which would in turn stimulate labour supply and exposure to taxation. In essence, a proportional tax system would encourage low wage earners to earn more and high wage earners not to earn less. It would be simple to maintain and manage, and tax avoidance strategies would not be as prominent.

On the other hand, high income earners would pay less tax proportionally, and low income earners more. But average tax rates for high income earners have been steadily reducing over time. Low income tax offsets and safety nets could remain in place, ensuring low income earners are no worse off. While investment income earners would no longer have a nil tax environment to minimise tax, which would surely appease the franking credits detractors, for example.

Interestingly, proportional tax systems already exist in some East European countries, some having modified versions with tax-free thresholds or tax offsets at low income levels. Efficiencies in tax compliance have been gained in those countries.

Significantly though, a proportional tax system would ensure that the incumbent government could not increase the tax take by stealth.

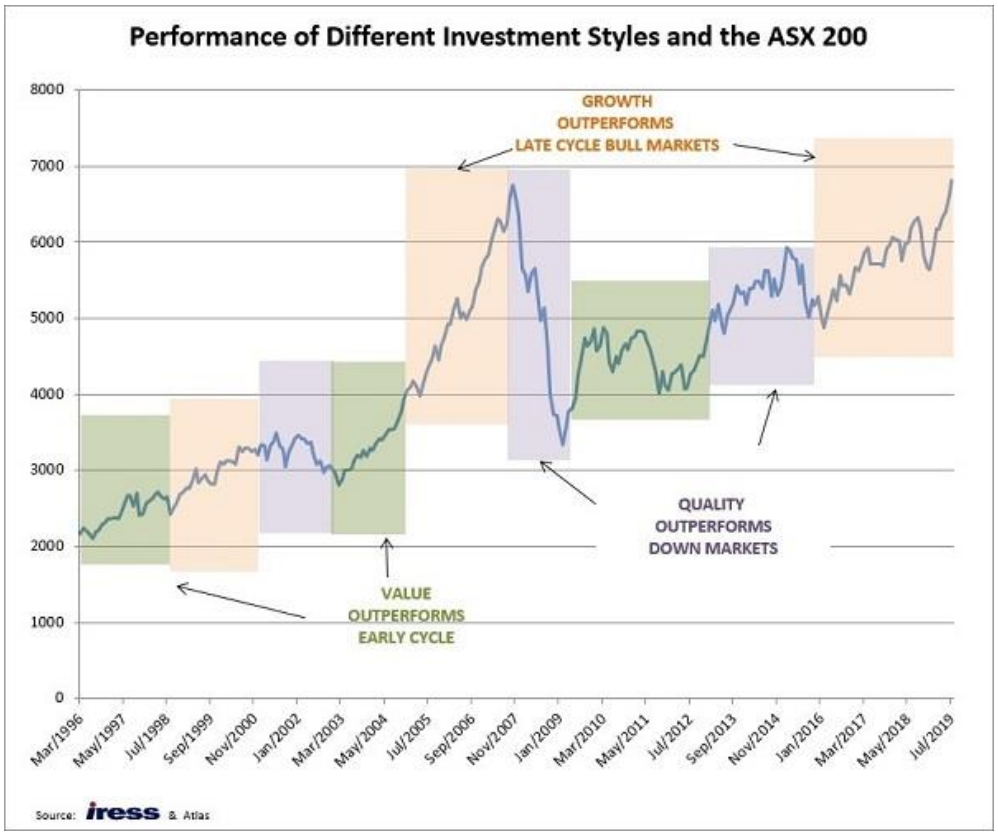
Tony Dillon is a recently-retired actuary.

How do different investing styles work?

Hugh Dive

There has been heightened focus recently on different investment styles, with articles such as "Is value investing dead?" The analysis generally centres around the triumph of growth investing and the demise of value-style investing.

Investors looking for professionally-managed equity portfolios face a vast array of options, with the different portfolio managers building portfolios based on their individual investment philosophies or investment styles. This piece examines the foundations upon which these styles are built.



Index funds

An index fund manager attempts to match the return of the underlying index less a small management fee. The manager will automatically buy Fortescue to its current index weight of 1.3% and make no judgement on the company's valuation, or whether iron ore will stabilise at US$120/tonne or fall back to US$60/tonne. If Fortescue's weight in the index increases due to its share price outperforming, the weight in the portfolio rises automatically. Similarly, as AMP's fortunes have declined over the past 18 months, its weighting in the index portfolio has fallen.

While index funds can be a cheap way to obtain exposure to the equity market, investors are exposed to all companies – good or bad, overvalued or undervalued. For example, in 1987 and 2007 the index contained companies such as Bond Corporation, Qintex, Allco, Babcock & Brown and Centro, all of which subsequently went into liquidation. I observed a more extreme example as a young analyst working in the Canadian market, where telecommunications equipment company Nortel in 2000 comprised 35% of the benchmark Toronto Stock Exchange 300.

It seemed clear before their fall that these were companies with shaky business models reliant on high levels of leverage, and in the case of Nortel, irrational market valuation. Not owning companies such as these caused many fund managers to underperform relative to the index, however their investors avoided the losses as these former high-flyers lurched into administration.

Growth funds

Funds managers using the growth style of investing tend to select securities based more on the brightness of the company's prospects, rather than the company's current profits and dividends. The growth manager builds a portfolio of companies such as accounting software company Xero or payments company Afterpay based on the assumption that the market is underestimating their growth prospects.

The rationale is that Xero's earnings and dividend yield are expected (by the growth manager) to rise rapidly. This provides justification for buying a company that is trading on a price-earnings multiple of 246 times next year's earnings per share (EPS) and does not pay a dividend. Unlike an index fund, analysts at growth funds spend many hours meeting with a company's management team and industry contacts to understand why the company's long-term profit growth is likely to exceed the market's current optimistic assumptions. In 2009, CSL was trading at $31 per share and had earnings per share of $1.92 and the company was viewed as expensive, trading at a PE (price to earnings) ratio of 16 times. In August 2019, CSL is expected to deliver earnings per share of $6.05 which, based on an initial purchase price 10 years ago, puts the blood therapy company on a reasonable PE of 5.1 times with an 8.8% dividend yield.

Growth as an investing style tends to outperform when the stock market is rising sharply as investors overestimate company earnings and minimise potential problems such as debt refinances and the entrance of new competitors. Also, in the case of growth companies such as Afterpay, when the company's share price is up 63% in the past 12 months investors don't care about not receiving a dividend.

Value investing

Value-style funds pick stocks that are trading below their net worth. Benjamin Graham and David Dodd famously developed this style in their seminal investing text from 1934, *Security Analysis*(not a light read by modern standards with 725 densely-packed pages and few graphs). Value investing is based on the concept that undervalued stocks will revert to their intrinsic value, thus allowing the investor to buy (for example) $1 worth of assets for 80c.

Characteristics of this investing style include buying companies that are trading on a low price to book value, low PE ratio, or companies whose liquidation or wind-up value is greater than their current market value. In July 2018, Telstra was trading at $2.60 which equated to 13 times its projected earnings per share and with a dividend yield of 7%. The market was concerned about increasing competition in the mobile phone market in Australia and the impact of the NBN on profit margins. Over the past year, Telstra's share price has rallied to almost $4 due to a combination of decreasing price competition in mobiles and government decisions to block rival TPG from both building a 5G network (using Huawei technology) and merging with UK-based Vodafone. Telstra currently trades on a PE ratio of 25 times with a 4% dividend yield.

Typically, a value-style fund will have a lower price to earnings ratio, lower beta (a measure of volatility) and a higher dividend yield than a growth-style fund, with greater exposure to more mature companies. One of the dangers of value-style investing is being attracted to companies that are 'value traps', namely those that have

a high but unsustainable historical dividend yield and low PE ratio as they operate in a declining industry. While department store owner Myer has recovered in 2019, this company is viewed by many as a value trap.

Quality investing

Following the Dot Com Bubble of the early 2000s and the aftermath of the GFC, investors paid more attention to the quality of a company, rather than just its raw earnings multiple or dividend yield. This approach focuses on hard factors such as the quality of a company's earnings or balance sheet, along with softer factors such as the quality of corporate governance and transparency of information, while still buying undervalued companies. Quality-style fund managers tolerate paying more for companies with higher quality recurring earnings streams and tend to avoid cheap companies that are in the process of restructuring. This is the approach we use at Atlas Funds in managing our equity portfolios.

In the case of improving quality, the market may see a company as low quality when in fact the underlying fundamentals of that company are improving. For example, in early 2017 private health insurer Medibank was added to our portfolios. At this time, we considered that the market was not pricing the potential profit uplift that Medibank's management could generate from cutting out costs and inefficiencies that crept in over the decades of government ownership. As the market recognised these qualities, the share price has moved steadily upwards. The Coalition's election victory in May also improved the company's prospects.

Hugh Dive is Chief Investment Officer of Atlas Funds Management. This article is for general information only and does not consider the circumstances of any investor.

(Thanks for reader comments on an earlier version of this article, which has been updated).

Vital lessons from the long-term Index Chart

Robin Bowerman

Information overload is a modern day problem.

Between smartphones, websites and watches that alert you even when you have ignored the phone, it is hard, if not impossible, to tune out the noise of the world. Trade wars, Brexit, currency slumps and geopolitical tensions are just the headlines that can dominate the news cycle on any given day. Thankfully the Australian cricket team provided some welcome relief – and restored a little national pride – at Edgbaston this week.

A long-term look at markets

Vanguard has been publishing its annual index chart that plots the performance of all the major markets and asset class indices for Australian investors for 18 years. It allows investors to look at how markets have rewarded them for the risk taken through periods of market rises and periodic slumps.

This year's chart provides the data to June 30 2019, and naturally there is always a tendency to focus on what has topped the performance table. While interesting, that is not the key message from the chart.

The core message – and the reason for continuing to publish it over such an extended period of time – is to understand the power of markets over the long-term.

Think of a major event that roiled investment markets and look at that point on the chart, say, the last Australian recession in 1992 or the collapse of Lehman Bros in 2008 to understand its impact at the time. Then zoom out to see how it affected returns over the full 30-year time period covered by the chart.

The other message provided by the index chart is when investors lean towards wanting to predict what will be the top performing asset class next year … and the year after that.

You can view the digital version of the chart here (or order a print copy here) but if you are tempted to try and time markets, it's worth taking a look at the table below of the index chart brochure which shows the total returns across all the major asset classes featured in the chart.

Financial year total returns (%) for the major asset classes

	Australian Shares	International Shares	International Shares (Hedged)[1]	US Shares	Australian Bonds	International Bonds (Hedged)[2]	Cash	Australian Listed Property	International Listed Property[3]
1990	4.1	1.9	5.3	11.2	17.8	13.1	18.5	15.2	
1991	5.9	–2.0	–5.8	10.8	22.4	15.3	13.5	7.7	–15.9
1992	13.0	7.1	–3.0	16.5	22.0	15.8	9.0	14.7	6.9
1993	8.7	31.8	17.3	27.9	13.9	14.7	5.9	17.1	28.3
1994	15.5	0.0	6.7	–7.8	–1.1	2.1	4.9	9.8	8.4
1995	6.4	14.2	3.7	29.9	11.9	13.1	7.1	7.9	7.5
1996	14.3	6.7	27.7	13.5	9.5	11.2	7.8	3.6	2.4
1997	26.8	28.6	26.0	41.5	16.8	12.1	6.8	28.5	35.7
1998	1.0	42.2	22.1	57.5	10.9	11.0	5.1	10.0	25.0
1999	14.1	8.2	15.9	14.9	3.3	5.5	5.0	4.3	–6.8
2000	16.8	23.8	12.6	18.2	6.2	5.0	5.6	12.1	14.1
2001	8.8	–6.0	–16.0	0.6	7.4	9.0	6.1	14.1	38.2
2002	–4.5	–23.5	–19.3	–25.8	6.2	8.0	4.7	15.5	7.5
2003	–1.1	–18.5	–6.2	–16.1	9.8	12.2	5.0	12.1	–5.2
2004	22.4	19.4	20.2	14.7	2.3	3.5	5.3	17.2	28.7
2005	24.7	0.1	9.8	–2.8	7.8	12.3	5.6	18.1	21.2
2006	24.2	19.9	15.0	11.5	3.4	1.2	5.8	18.0	24.2
2007	30.3	7.8	21.4	5.6	4.0	5.2	6.4	25.9	3.0
2008	–12.1	–21.3	–15.7	–23.2	4.4	8.6	7.3	–36.3	–28.6
2009	–22.1	–16.3	–26.6	–12.4	10.8	11.5	5.5	–42.3	–31.2
2010	13.8	5.2	11.5	9.5	7.9	9.3	3.9	20.4	31.3
2011	12.2	2.7	22.3	3.1	5.5	5.7	5.0	5.8	9.2
2012	–7.0	–0.5	–2.1	10.1	12.4	11.9	4.7	11.0	7.5
2013	20.7	33.1	21.3	35.0	2.8	4.4	3.3	24.2	24.3
2014	17.6	20.4	21.9	20.8	6.1	7.2	2.7	11.1	11.8
2015	5.7	25.2	8.5	31.9	5.6	6.3	2.6	20.3	23.1
2016	2.0	0.4	–2.7	7.3	7.0	10.8	2.2	24.6	20.4
2017	13.1	14.7	18.9	14.4	0.2	–1.0	1.8	–6.3	–4.8
2018	13.7	15.4	10.8	18.7	3.1	2.5	1.8	13.0	9.0
2019	11.0	11.9	6.6	16.3	9.6	7.0	2.0	19.3	13.5
Average	10.0	8.4	7.6	11.8	8.3	8.5	5.7	10.6	10.6
Best	30.3 (3)	42.2 (2)	27.7 (5)	57.5 (6)	22.4 (3)	15.8 (3)	18.5 (1)	28.5 (3)	38.2 (4)
Worst	–22.1 (2)	–23.5 (3)	–26.6 (4)	–25.8 (3)	–1.1 (2)	–1.0 (2)	1.8 (7)	–42.3 (3)	–31.2 (4)

(X) denotes the number of times each asset class was the best/worst performer during a financial year ending between 1990 and 2019.
Source: Andex Charts Pty Ltd.
Notes: 1. MSCI World ex-Australia Net Total Return Index (Local Currency) – represents a continuously hedged portfolio without any impact from foreign exchange fluctuations. 2. Index prior to 30 June 2008 is the Citigroup World Government Bond Index AUD hedged, from 30 June 2008 the index is the Bloomberg Barclays Global Treasury Index in $A (Hedged). 3. Prior to 1 May 2013, index is the UBS Global Real Estate Investors Index ex-Australia with net dividends reinvested. From May 2013 the index is the FTSE EPRA/NAREIT Developed ex AUS Rental Index with net dividends reinvested. Past performance is not an indicator of future performance.

No discernible performance pattern

The best and worst performing asset classes are highlighted across each year, and feel free to let us know if you spot a performance pattern because what we see is what Burton Malkiel captured so elegantly in his investment classic, *A Random Walk Down Wall Street.*

The index chart shows the performance of markets over the long term, but for individual investors its value is in understanding how you blend all of those markets to create a portfolio with the right asset allocation to achieve your investment goals within a risk level that you are comfortable with.

For investors, a sense of perspective is a critical tool in the armory that can help tune out short-term noise, focus on your long-term goals and, as the legendary founder of Vanguard, Jack Bogle said, help you to "*stay the course*".

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